



Azerbaijan Country Overview



BASIC FACTS:

Capital: Baku
Area: 86,600 square kilometers
Population: 7.95 million (July 1998)
Currency: Manat
Exchange Rate: \$1 = 4,578.77 (6/01)
GNP: \$3.7 billion (1999)
GDP Growth: 10.0% (1998); 7.4% (1999);
GNP per capita: \$406 (1999)
Inflation: 8.9% (1999)

EXECUTIVE SUMMARY

Azerbaijan lies to the west of the Caspian Sea, and is strategically located between Russia to the north and Iran to the south. The country is one of the oldest oil exporters in the world and used to service much of the former Soviet Union with tools and equipment for the oil and gas industry. It also has fertile agricultural land and a well-educated labor force. With a cease-fire agreement with Armenia over the disputed Nagorno-Karabakh region now in its fifth year, prospects look quite good for a sustained period of economic growth and development.

Azerbaijan has enormous economic potential, particularly in the energy sector. Although no official estimates exist for the country's total reserves, industry experts suggest that Caspian reserves may approach those of the North Sea. As a result, virtually every major oil company in the world has an interest in Azerbaijan. Over the next 10 years, the United States Commerce Department has projected that total investment in Azerbaijan's oil and gas sector could reach \$23 billion. Realization of this potential will require the establishment of a framework for development rights to offshore oil among the states bordering the Caspian Sea, as well as transport rights through neighboring countries and the construction of new export pipelines.

About seventy American companies, primarily in the oil and gas sectors, are now resident in Baku. Azerbaijan's largest trade event, the Caspian Oil and Gas Exhibition (COGE), is held annually the first week in June. In June 1999, the Sixth COGE attracted more than 300 companies from thirty countries.

Realization of investment opportunities has been assisted by the implementation of market-oriented legal and institutional reforms. As in other countries in the region, Azerbaijan has gone from a period of severe economic contraction during the early 1990s to a period of positive GDP growth rates (estimated at 7.4% in 1999). During this transition, the Government has been able to reduce inflation from more than 1,600% to less than 8.9% in 1999. Privatization has resulted in 90% of the agricultural land and most small businesses being transferred to private ownership. A number of laws are in place that protect foreign investment and allow for repatriation of profits and convertibility of currency. To date, 14 production sharing agreements (PSAs) have been signed with foreign oil companies, resulting in \$1.6 billion in investment.

Azerbaijan's ability to achieve its full potential will depend on establishing the rule-of-law, through resolution of conflicting laws or administrative decrees and ensuring the transparency and consistency of enforcement among all state bodies. Government licensing and regulatory practices in particular are characterized by overly broad discretionary authority and a lack of transparency in enforcement. While the giving or accepting of a bribe is a criminal act, corruption is still a major problem facing investors in Azerbaijan.

The condition of Azerbaijan's public infrastructure, representing one of the most pressing constraints to successful development of the oil and gas industry, is also an area that represents good opportunities for U.S. companies. Since independence there has been almost no public investment or maintenance of public infrastructure. Roads are inadequate and deteriorating. The electrical generation and distribution system is in poor condition. Eighty percent of arable land is irrigated, but the irrigation system is collapsing. In an effort to address these issues, the World Bank and other donors are developing programs which will result in significant investments in the short term.

ECONOMIC OUTLOOK

In the medium term, Azerbaijan's economic prospects are strong. They could be enhanced further by continued progress in economic and political liberalization, and the construction of necessary pipeline and other transport links to international markets. The Government of Azerbaijan will need to continue implementing a serious economic reform program, and wisely invest the revenue generated by the development of its energy resources, for this to occur.

Energy remains the keystone of Azerbaijan's economic future. In this regard, oil production is projected to peak between 1.5 and 2 million barrels per day between the years 2010 and 2015. However, despite its potential oil wealth, it still faces several years of tight finances, as the GOAZ will not receive revenues from Production Sharing Agreements (PSAs) until costs of initial outlays are recovered, a fact that may preclude substantial GOAZ revenues (other than signing bonuses) until well into the next decade. Recent discoveries of major offshore gas deposits will be used both to supply Azerbaijan's energy needs and to generate needed revenue from exports to Turkey and Eastern Europe.

Azerbaijan's economic future depends on how the GOAZ proceeds with economic reform and uses the revenue from its energy resources. Despite its oil wealth, and a flourishing trading sector, there has been slow progress toward a market economy. Under a three-year agreement with the IMF signed in December 1996, the GOAZ has continued the policies of fiscal and monetary austerity first adopted in 1995. As a result, inflation fell and the Azeri Manat (AZM) was relatively stable at 4000 AZM to the US\$ until recently when it was devalued. The new exchange rate as of end July was US\$ 1 = 4741 AZM. Reflecting this change, prices for imported food products have risen 10-15%.

Development of Azerbaijan's substantial oil and gas resources will depend on its ability to attract foreign investment, which in turn depends in part on making continued progress in economic and institutional reform. The GOAZ has made good progress in improving its external sector balances. The current account deficit of \$915 million in 1997 was financed mainly through foreign direct investment (FDI) inflows of about \$1 billion, mostly related to oil exploration and development. Official foreign exchange reserves by end-1997 had risen to four months worth of imports, compared to almost non-existent reserves in 1994. Preliminary figures for 1998 indicate that FDI continued to increase, although the current account deficit rose faster. The exchange rate has remained steady and there was no discernible premium in the black market as of early 1999.

Key in their switch to a free-market economy has been the move toward privatization, which began in 1996. The program calls for the privatization of 70% or more of all state-owned enterprises (SOEs). Implementation of the privatization effort is the responsibility of the State Property Committee. Between the period of May 1997 to December 1998, more than 20,600 companies were privatized, and proceedings started for many others.

A privatization program providing for the sale of two-thirds of state assets in the productive sector has proceeded at a quick pace. About 13,000 small enterprises have been sold through cash auctions, while more than 500 medium-scale enterprises have been privatized through voucher auctions. About 95 percent of the population have received vouchers which can be used to purchase shares in the privatized enterprises. A key aspect of the Government's reform program is land reform and restructuring. In early 1995, it introduced laws on agrarian reform and reform of state and collective farms. The July 1996 Land Reform Law has facilitated the transfer of land to private and collective ownership. Land titling and land registration systems have been put into place.

The Government's structural reforms have also made considerable headway. Both domestic and foreign trade regimes have been substantially liberalized with the abolition of the state order system, export and import quotas, licensing requirements and the export registration scheme. External tariffs have been simplified with reduced dispersion. There are three tariff rates (i) 1.5 percent for most items, (ii) 5 percent for intermediate goods, and (iii) zero for investment goods. State-owned trading companies involved both in exports and imports, including the cotton monopoly, have been either privatized or liquidated.

Outside of oil exploration and production, the strongest prospects in the economy are providing supplies and services to support the oil and gas industries. Baku's expatriate community and a relatively small moneyed class of Azerbaijani's are also

creating demand for recreation, entertainment, and retail services in the capital. The national infrastructure, built in the Soviet period, is in poor condition. Since independence there has been almost no public investment or maintenance of public infrastructure. Roads are inadequate and deteriorating. The electrical generation and distribution system is in poor condition. Eighty percent of arable land was irrigated, but the irrigation system is virtually inoperable. Baku experiences shortages of gas, water, and electricity. Elsewhere in the country, the electricity supply is poor, and gas supply is almost non-existent. Public utilities are financially crippled by their inability to collect payment from their customers.

BUSINESS AND INVESTMENT CLIMATE

As in other countries in the Caspian Sea region, the GOAZ's official policy is to promote foreign investment. In 1992 the GOAZ passed the Law on Protection of Foreign Investments, which establishes the basic principles of foreign investment in Azerbaijan and extends guarantees of legal protection to foreign investors. Contract enforceability is also guaranteed; any subsequent legislation which may change the status of the contract is not retroactive. Foreign participation is possible through joint ventures with local companies, wholly foreign-owned enterprises, and representative offices. Participation of foreign investors in certain areas, such as the energy sector, requires prior approval of the Cabinet of Ministers (and in some cases, President Aliyev).

According to the privatization law passed on September 29, 1995, foreign investors may participate in Azerbaijan's mass privatization by acquisition of state privatization options. On July 16, 1996, Azerbaijan's parliament passed a land law, which allows for private ownership of land (90% of the farmland is in private hands), but precludes ownership of land by individual foreigners. However, experts believe that the new law will enable companies owned by foreigners to own land in Azerbaijan. Finally, there are no restrictions on converting or transferring funds; nor are there any restrictions on the remittances of profits.

Despite the above positive developments and legal assurances, there still remain a number of constraints which affect both Azerbaijan and the region in general. Poorly defined and/or vague laws often only take on meaning through implementing decrees and regulations — some of which are not published. There are often differences between policies established by the GOAZ and procedures followed by executive agencies. Also, there can be a lack of co-ordination among Parliament, the various Ministries and the President's Office resulting in some laws being passed which may appear to conflict with one other. Finally, corruption is perhaps the major problem foreign investors face in Azerbaijan. Although state leaders have repeatedly proclaimed the struggle against corruption the most urgent task, the situation has not improved.

POLITICAL CLIMATE

Azerbaijan became an independent republic in December, 1991 and established diplomatic relations with the United States in early 1992. The two countries maintain close political and economic relations, and in FY98 the U.S. Government transferred more than \$60 million in assistance to Azerbaijan. A U.S.-Azerbaijan bilateral trade treaty, ratified in April 1995, is in effect. The U.S. and Azerbaijan signed a bilateral investment treaty in August 1997.

During the past several years the political climate in Azerbaijan has stabilized. Still, there remain a number of issues on which the Government is making intermittent progress. The first post-independence parliamentary election, in November 1995, was flawed, although some opposition candidates were seated. Azerbaijan's system of Government grants broad powers to the President. The presidential elections in October 1998, the major political event of 1998, were an improvement over previous elections, but still fell short by international democratic standards. Azerbaijan has taken several steps toward a more open society, including the elimination of censorship. Still, the lack of an independent court system and a scarcity of qualified lawyers make it difficult to protect the legal rights of individuals.

A key issue that will continue to affect economic development in the country is the on-going conflict with Armenia. A cease-fire agreement with Armenia over the disputed Nagorno-Karabakh region has been in effect since May 1994, and this has clearly been a factor underpinning the return to strong economic growth in Azerbaijan.

SOURCES OF FINANCING

The Azerbaijani banking system is small, weak, and as yet plays a minimal role in the economy, which mostly functions on cash. As of July 1997, there were four state-owned banks, ninety-three private Azerbaijani banks, and six foreign-owned banks. Private banks are small and are expected to decline following the increase of minimum capital requirements from \$600,000 to \$800,000. Some of the stronger ones service foreign companies and have correspondent relationships with U.S. banks. These include Rabitobank and Demiryol Bank.

Most western businesses use one of two banks for their local transactions — International Bank of Azerbaijan, the healthiest state-owned bank, or British Bank of the Middle East's Baku branch, a subsidiary of the HSBC Group. Both of these have correspondent relationships with U.S. banks. Western businesses generally use local banks only for local payments. Of the four state-owned banks, only International Bank is a fully-functioning commercial bank, while the other three are insolvent and going through a World Bank-designed restructuring program.

The ISA is currently in the process of being privatized. The Azeri government has selected a financial consultant to assess the value of its assets in the Bank and advise them regarding all investment proposals received. It is expected that the

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Both the International Bank of Azerbaijan and the British Bank of Middle East have correspondent relationships with U.S. banks.

OPIC, TDA, EXIM and AID now operate in Azerbaijan. U.S. EXIM Bank has signed a limited Project Incentive Agreement with Azerbaijan, but it is not yet operational. The World Bank and EBRD are both active in financing public infrastructure projects in Azerbaijan.

TELECOMMUNICATIONS

With the rapid growth of oil and gas investment in Azerbaijan since 1994, the telecom sector has attracted increasing foreign investment. An expected increase in the number of tenders in the oil and gas sector, for onshore, offshore, and pipeline projects, will also result in opportunities for US telecommunications equipment suppliers, operators, and system integrators.

The Ministry of Communications acts as both a regulator of the industry as well as a joint venture participant, holding majority shares in many, but not all joint ventures. In 2001-2002, US firms should monitor direct contract and sub-contracting opportunities to the international oil consortia, which will require expanded telecom services, particularly for data. In 2001, a tender may be issued for the third GSM license in Azerbaijan, while it is unclear when the state's 51% share in Aztelecom will be sold.

Wireless communication is presently the most active sub-sector of the telecom industry in Azerbaijan. It has continued to receive considerable foreign investment since 1994, when the GSM 900 network was initiated. There are two mobile operators in Azerbaijan – Bakcell (GSM 2000) and Azercell (GSM 900). Mobile communications operators have a key competitive advantage since they do not have to adhere to the low telecom tariffs dictated by the Azerbaijani Government. Since telephone density in Azerbaijan varies from region to region, -- reaching as high as 50% in Baku, the national capital, and as low as 10-15% in small towns, -- wireless mobile and wireless local loop are often the only alternatives to obsolete and inefficient wireline networks. With recent investments into the mobile communications sector, international telecom equipment manufacturers and service providers indicate that some market players are ready to invest based on expectations of long term future dividends. The Ministry of Communications is talking to several companies for establishing a third mobile operator in Azerbaijan. Currently, Azercell is the largest mobile communications operator with more than 400,000 subscribers, most on the popular, pre-pay Sim Sim program. Prepaid mobile communications services, mobile banking, Internet, SMS and other value-

added services have allowed mobile communications operators to attract customers from other telecom sectors, such as paging and trunking.

The Azeurotel 92/97 exchange represents the only Azerbaijan-based telephone operator utilizing the powerful System X digital switching system. Azeurotel, a UK-Azeri joint venture with Lukoil participation, is the platform for a variety of telecommunication services: local telephone network, national and international communication, multipurpose trunking communication, Nokia Actionet, and packet data transmission. Today the 92/97 Exchange is connected to all stations of Baku by fiber-optic cable, where SDH multiplexing equipment is installed and thus allowing an increase in the number of channels with great capabilities for data and voice transmission. Azeurotel is also utilizing the DECT standard wireless network system. It is a uniquely digital standard and therefore provides all digital communication services including ISDN. The sphere of DECT application ranges from the simple wireless telephone to the system providing various telephonic services.

INFORMATION TECHNOLOGY

The Azeri IT market features several strong local firms providing the latest IT technologies and full integrator services. Most Azeri computer hardware and software sales companies offer system integration to their clients. Azerbaijan Electronics (AZEL) has been in the leading position as system integrator since 1991 and now deals with delivery of complete solutions and service support for corporate clients using Hewlett-Packard, Microsoft, APC, Toshiba, Compaq, Daewoo, Oracle, AutoDesk, JVC, BASF, IBM and other suppliers. Azel's strategy was and remains integrated solutions in the field of information technology. The R.I.S.K. COMPANY offers cohesive business process consultancy, application consultancy and IT infrastructure consultancy, based on technology planning, lifecycle cost management and project planning.

The Azeri Internet services market is young and limited but has strong prospects for development. Internet penetration is still low at only 12,000 subscribers countrywide, however Azeri firms and IT-savvy Azeris are showing more and more interest in the Internet. The overall economic situation, the business environment for small and medium size companies, the role of the Ministry of Communication as both regulator and commercial partner, and very limited Azeri purchasing power will determine the pace of Internet market growth. Another factor to consider is the level of integration into Western markets. Differing from the U.S. and Western Europe, the Azerbaijani market for Internet services depends more on the availability of telecom and computer infrastructure than on demand for ISP services. This dependence is due to the monopoly of Aztelecom in the public telephone system and the high charges for access to international channels. Identified obstacles to the development of Internet services are: the lack of local loop development; legislation that would determine the legal status of Internet-related businesses (e.g. Internet telephony, e-commerce, information security, encryption products, etc.); and lifting of price (i.e. VSAT) and other monopolistic measures increasingly taken by the Azeri government.

Internet services are subject to licensing by the Ministry of Communications. All ISPs are established as joint ventures with the Ministry of Communications. In these JV charters, the Ministry is usually a shareholder of 51% of the venture and provides general facilities as its portion of the charter capital, while the other partner is expected to provide operating and investment capital in the venture and be an operator of the company. There are no official statistics for the number of Internet users in Azerbaijan, however, the U.S. Embassy estimates that there are approximately 12,000 Internet users in Azerbaijan. Main users are corporate businesses, the local private sector, educational centers, and academia. The ISP sector is currently viewed as low in profitability with the need for reinvestment reaching 95 percent based on some anecdotal evidence. However, this sector performs better than other ICT industries.

To expand the local market for Internet services, Azerbaijan needs to create its own backbone network. The Ministry of Communications has announced a tender for construction of the Azerbaijan portion of the Trans-Asia - Europe fiber-optic cable link. Once this cable is constructed, it will enable Azerbaijan to access global communications channels throughout Europe and Asia. The project will take fifteen months to finalize. ISP companies that operate outside of Baku are at a disadvantage, because they have to pay both for access to international channel and use radio relay channels that are outdated and unreliable, or voice band frequencies of Aztelecom. In the near future regional ISPs may opt for more reliable satellite channels. Many of the larger ISP providers sense a growing demand for additional Internet connectivity. Increasing Internet traffic and expensive international channels have forced ISPs to look for affordable Internet over satellite solutions. This need potentially represents one of the best sales prospects for U.S. equipment manufacturers and network integrators.